TD Global Investment Solutions

Investor Knowledge 20 Minutes

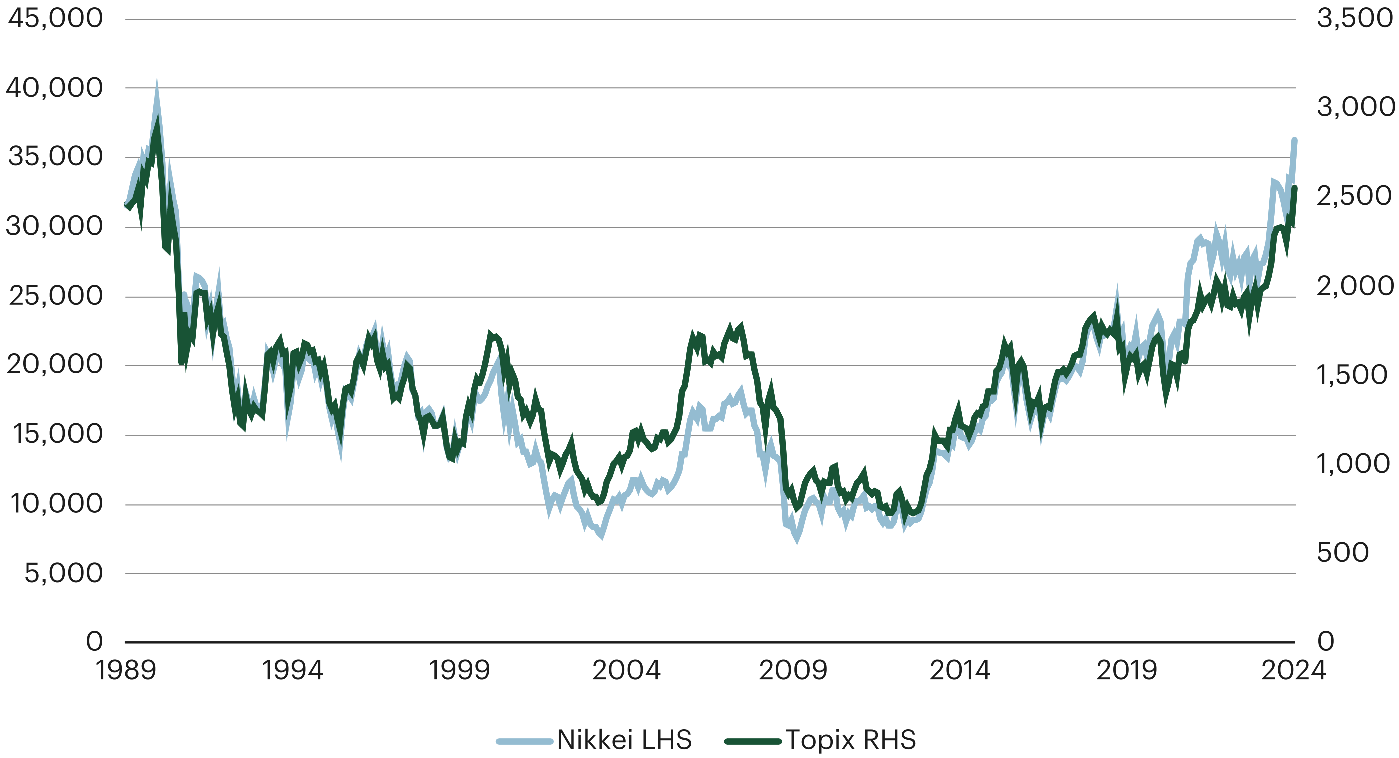
The rebound of Japanese equities:

how investors can navigate the tricky market

Karen Ko, CFA
Vice President and Director, Institutional Client Portfolio Manager, TDAM

Japanese equities have been grabbing headlines recently as their major stock indices are hitting new multi-decade highs in local currency terms. Since the country's economic bubble burst in the early 1990s, Japanese equites have seen extended periods of under-performance. A glimmer of hope was ignited when Shinzo Abe was elected Prime Minister in 2012 with his "three arrows" economic policy, which was based on monetary easing, fiscal stimulus and structural reforms. The first two arrows were quickly deployed and the market reacted positively. The Nikkei and Topix indices almost doubled between 2013 and 2015. The third arrow on structural reform has taken much longer to implement, though. Almost a decade later, Japan Inc. is renewing its focus on corporate governance reform, reminiscent of Abe's third arrow. Again, the market has taken notice. Will it be different this time?

Figure 1: Japan Topix and Nikkei indices



Source: Bloomberg Finance L.P. As of January 31, 2024.

The hype about corporate governance reform

The Tokyo Stock Exchange (TSE) is comprised of three market segments: Prime, Standard and Growth. The Prime section of the market has the highest requirements for liquidity and corporate governance. The Standard section has lower requirements compared to the Prime market, while the Growth market is for smaller and emerging companies.

In March 2023, the TSE requested all companies listed on the Prime and Standard markets to implement strategic policies that would enhance corporate value by tackling some fundamental issues that have long been regarded as thorns by investors. The TSE published a follow-up document in February 2024 to guide the country's corporations in addressing the key issues that investors expect Japanese CEOs to tackle.[1]

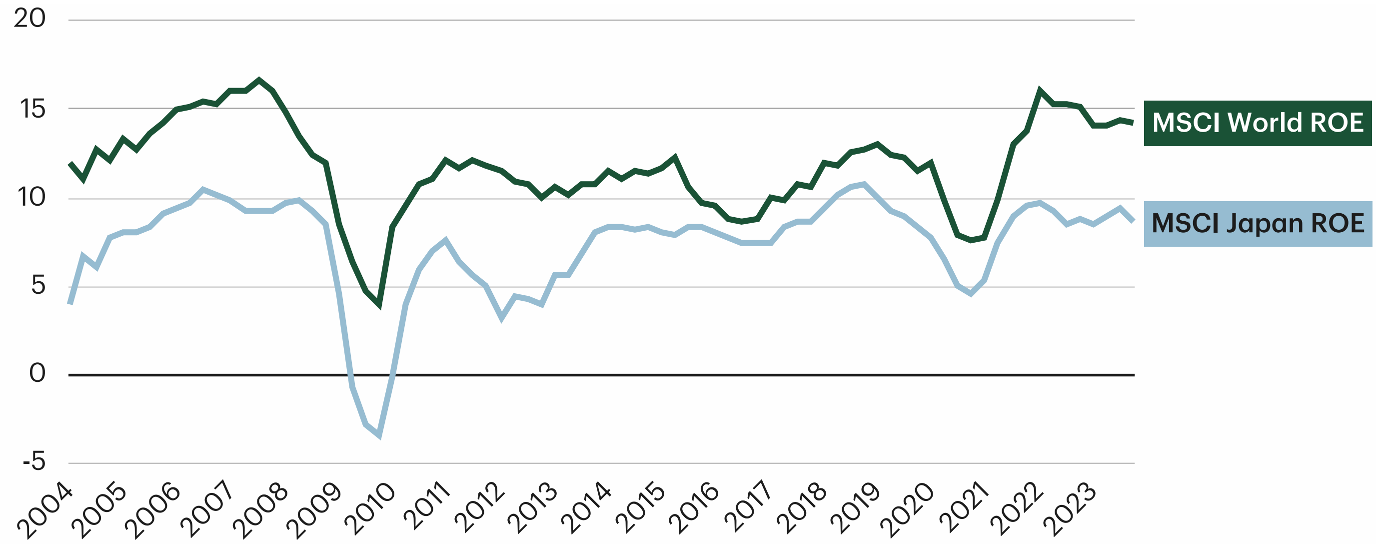
Quite a few activist investors have taken meaningful stakes in some Japanese companies and have been vocal about the need for initiating corporate reforms. In a recent high-profile example, Elliott Management called upon Mitsui Fudosan, Japan's largest property group, to launch a 1-trillion-yen buyback plan and dispose of its US$3.6-billion stake in Oriental Land, which runs Tokyo Disneyland.[2]

Low returns and misguided cost of capital

One persistent source of frustration for investors in Japanese equities is the consistently lower Return on Equity/Invested Capital (ROE/ROIC) that Japanese firms generate relative to their Developed Market (DM) counterparts. This can be attributed to lower profitability, but also a distorted view of their Cost of Equity/Weighted Average Cost of Capital (COE/WACC). Since the bubble burst in the early 1990s, Japan has been mired in deflation and low growth. Hence, its cost of debt and cost of equity is very low domestically. In the past decade, it was not uncommon for Japanese companies to have ROE assumptions of just 4%, so a project that generated a ROE of 6% was considered adequate. This pales by comparison with DM corporations, whose ROE ambitions are much higher.

[1] https://www.jpx.co.jp/english/news/1020/u5j7e50000001bqd-att/240201en.pdf
[2] https://www.cnbc.com/2024/02/05/mitsui-fudosan-hits-record-high-as-elliott-reportedly-demands-share-buyback-.html

Figure 2: MSCI World vs Japan ROE



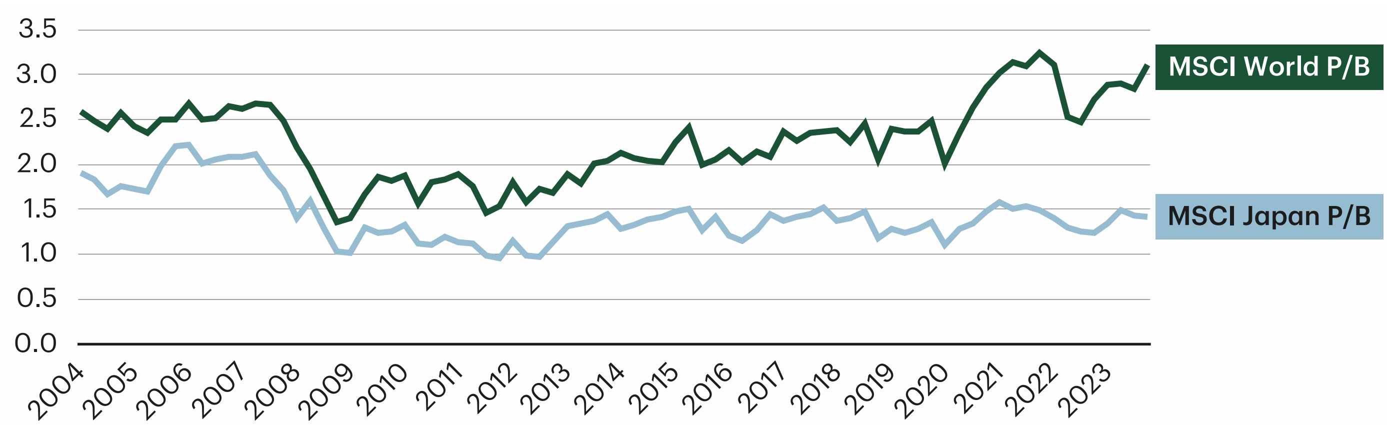
Source: Bloomberg Finance L.P. As of December 29, 2023.

In its February 2024 guidance, the TSE is advising Japanese corporations to consider the cost of capital as the investor's expected rate of return and to align perceptions with shareholders and investors about the level of cost of capital.

Low profitability and valuation

The TSE is explicitly targeting companies that trade below Book Value and it has warned them that they could face delisting as soon as 2026.[3] These companies tend to deploy capital inefficiently, so their growth is subpar and shareholders place a low value on their shares. Japanese companies have a long history of trading at a valuation discount compared to their DM peers.

Figure 3: MSCI World vs Japan Price-to-Book Ratio (P/B)



Source: Bloomberg Finance L.P. As of December 29, 2023.

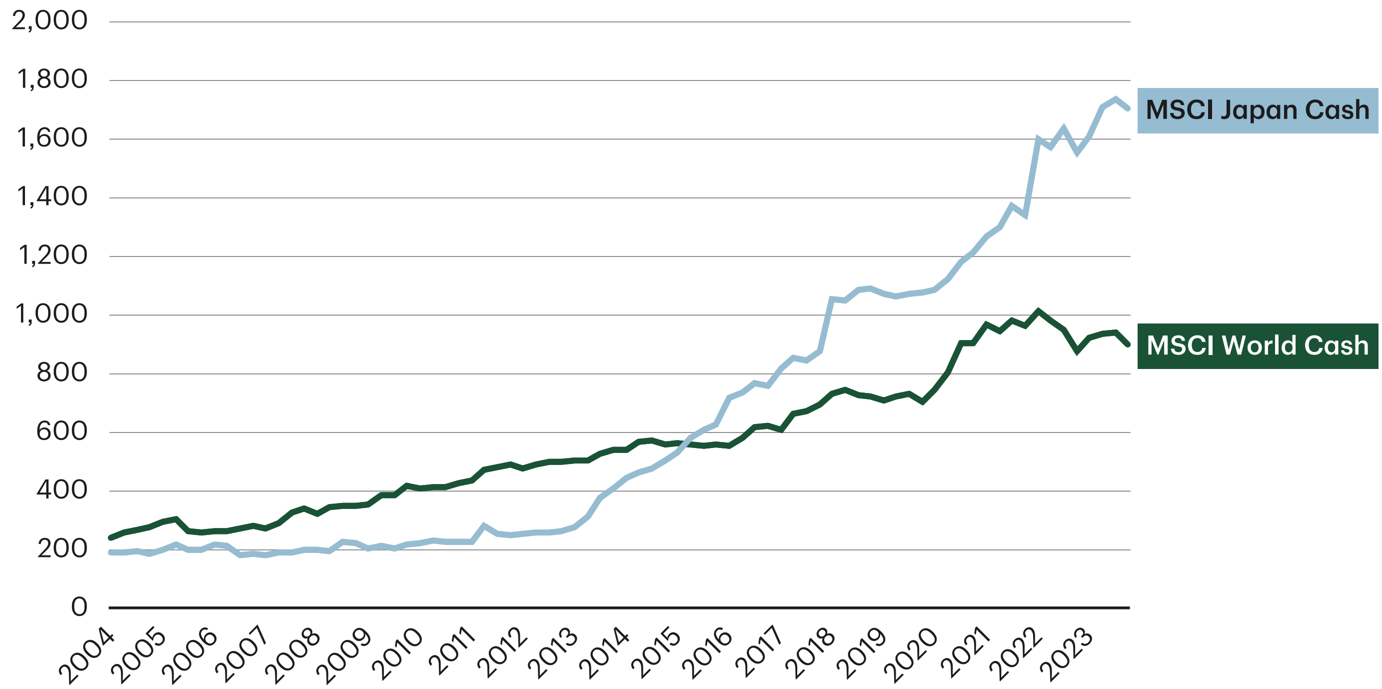
The TSE is advising Japanese corporations to continue pursuing higher profitability. Corporations should perform a strategic analysis of the competitiveness of their businesses and benchmark themselves with their peers. Companies are encouraged to do a deep dive into all their business segments and to draw up strategic plans for improving competitiveness and profitability.

[3] https://www.reuters.com/markets/asia/tokyo-bourse-proposes-2025-end-grace-period-listing-rules-2023-01-25/

Balance sheet efficiency

Japan's post-war economy has been dominated by the keiretsu structure – loose business partnerships between companies that hold each other's shares to help reduce share price volatility and discourage takeover attempts. The keiretsu structure is particularly prevalent in the manufacturing industry. These cross-shareholdings consume valuable capital that could otherwise be deployed to support growth and are another factor contributing to the lower profitability of Japanese companies. As a result, Japanese companies hold a larger amount of cash and short-term investments on their balance sheets than their DM peers.

Figure 4: MSCI World vs Japan cash and short-term investment per share



Source: Bloomberg Finance L.P. As of December 29, 2023.

The TSE is advising Japanese corporations to regularly inspect their balance sheets and ensure that they have an optimal structure to avoid having excess cash or other assets that do not contribute to value creation. Companies should provide a clearly articulated plan to address capital allocation in their business plan. We are beginning to see some large Japanese corporations taking steps to unwind equity stakes in affiliates and deploy capital in their core businesses. In late 2023, Toyota announced its intention to sell about 10% of its investments in auto parts manufacturer Denso and to deploy the cash into production of fully electric vehicles.[4]

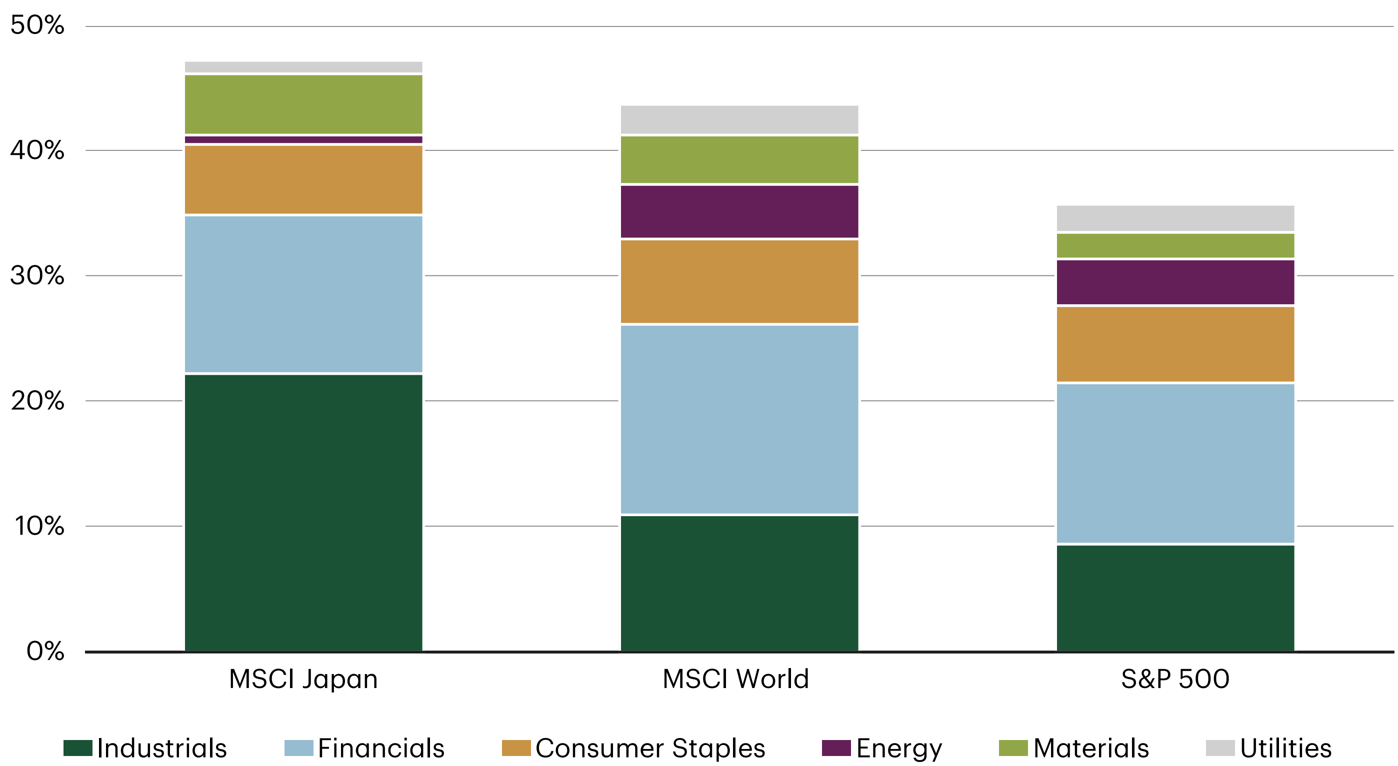
Equities

[4] https://www.reuters.com/business/toyota-group-companies-plan-47-bln-sale-denso-stake-sources-2023-11-28/

How TD Asset Management Inc. (TDAM) approaches the Japanese market

The TDAM Fundamental Equity team has a long tenure of managing multiple global and international equity strategies using the MSCI EAFE (Europe, Australasia and the Far East) and MSCI World indices as benchmarks. Japan is a significant component of these indices, representing 23.36% of the EAFE and 6.24% of the MSCI World as of January 31, 2024.[5] TDAM's fundamental equity strategies are oriented towards quality growth, so Japan presents structural challenges. For the reasons cited above, the Japanese market has a much higher proportion of value stocks, as well as being highly cyclical and displaying much more mean reversion – all attributes that are hostile to our quality growth style.

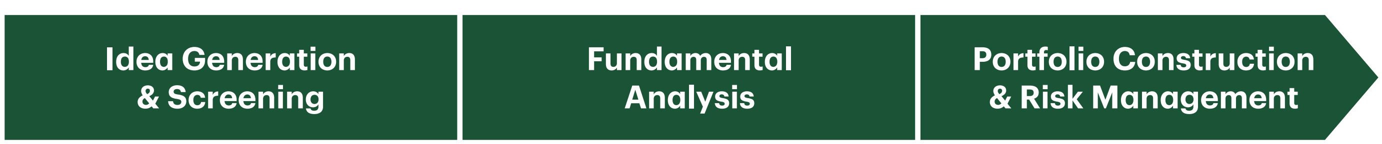
Figure 5: Traditional value sector weights



Source: MSCI and S&P Global. As of January 31, 2024.

Our Fundamental Equity team has addressed these challenges by developing a bespoke addition to our investment process that targets the peculiar features of the Japanese market.

Our fundamental equity investment process has three steps: idea generation and screening, fundamental analysis, and portfolio construction and risk management.



[5] https://www.msci.com/documents/10199/822e3d18-16fb-4d23-9295-11bc9e07b8ba
https://www.msci.com/documents/10199/178e6643-6ae6-47b9-82be-e1fc565ededb

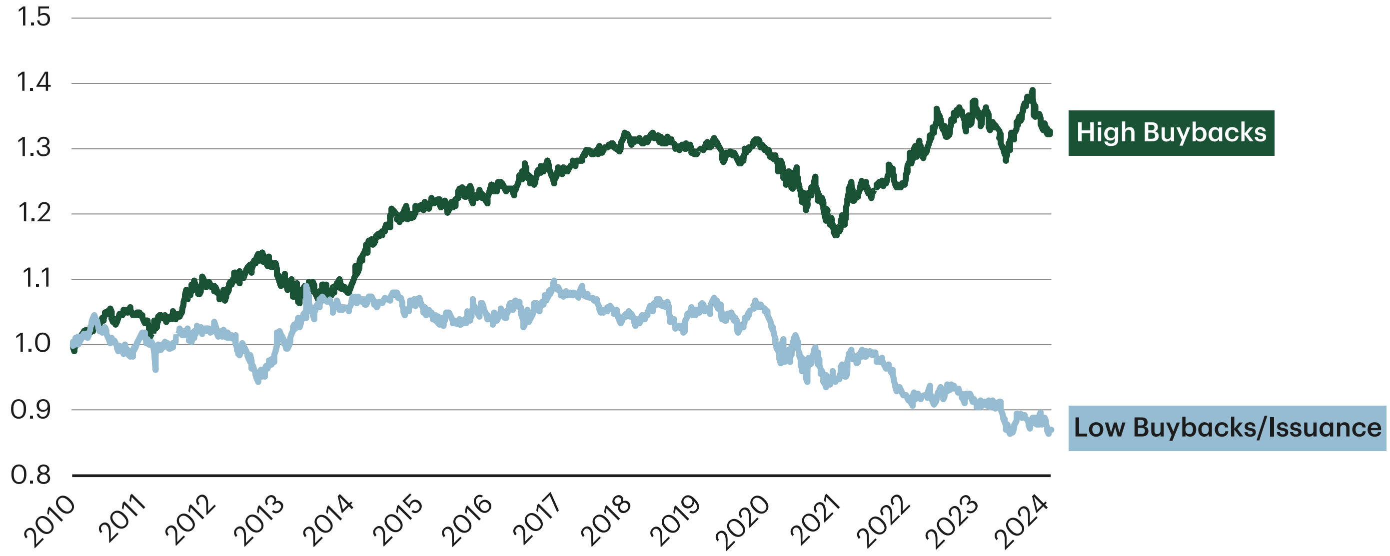
The first step – idea generation and screening – involves use of a proprietary screening tool. Built inhouse to ensure it is fully aligned with our investment philosophy, the screening tool is used to identify potential investment ideas which support the construction of concentrated, high conviction portfolios of quality companies that display good growth momentum. The characteristics we generally look for are earnings growth, growth momentum, profitability and valuation.

Key attributes we look for

TDAM's Empirical Research team regularly assesses the efficacy of these factors in global and regional markets. Over time, we observed that the screening tool was proving less effective for the Japanese market. In response, we developed a new screen in 2023 that better captures that market's cyclicality. Like the original propriety screen, the new tool is also a multi-factor screen, using the same broad categories but distinct factors that we have determined are stronger predictors of potential outperformance. For example, our analysis shows that share buybacks and gross margin are particularly effective indicators of future share price outperformance in the Japanese context.

Our Empirical Research team's analysis has revealed that Japanese companies which buy back a larger number of shares have consistently outperformed companies which buy back a smaller number or companies which issue additional shares.

Figure 6: Relative performance of shares buyback



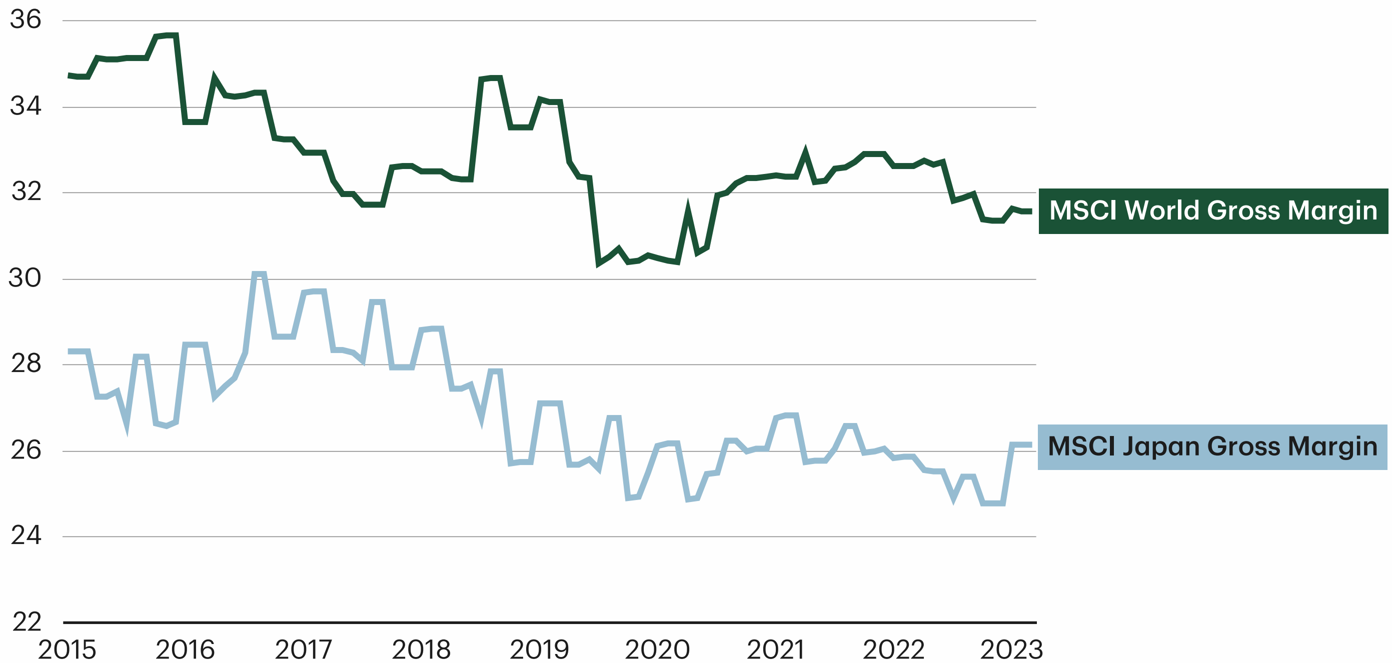
Source: FactSet. As of February 5, 2024.

The outperformance of Japanese companies that buy back a larger proportion of shares makes intuitive sense, given the inefficiency of Japanese corporate balance sheets and firms' misguided measurement of the cost of capital. With few investments generating sufficient returns for shareholders, buybacks have become a preferred use of excess capital – and, given the generally depressed valuations, they are being rewarded by the market.

As a result, we find that share buybacks are more effective than traditional valuation metrics such as P/E or P/B in identifying firms whose shares prices are likely to outperform. The underlying rationale is that a larger portion of the Japanese market is value-driven, but it doesn't create sufficient economic value-add in the long run. Knowing this, it is clear that many low P/E companies, far from presenting attractive upside, could in fact become value trap landmines.

Another factor that has been effective is gross margin. As illustrated in Figure 7, Japanese corporates have lower margins than DM corporates at an aggregated level.

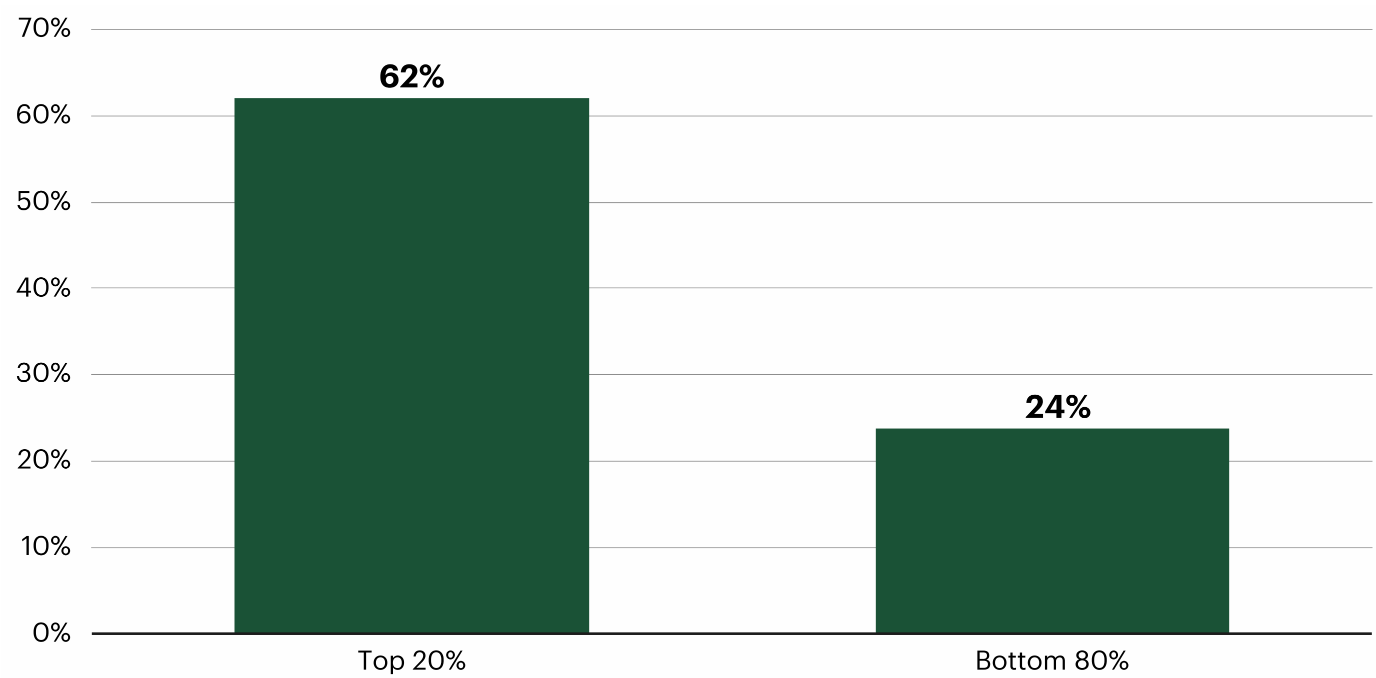
Figure 7: MSCI World vs Japan gross margin



Source: Bloomberg Finance L.P. As of January 31, 2024.

However, there is a wide gap between companies that produce high margins and those that produce low margins. The top 20% of Japanese companies produce significantly higher gross margin than the bottom 80%. Due to the scarcity of highly profitable firms, the companies with higher margins are attracting investment funds, which supports their outperformance. Our new screening tool is customized to identify these higher-margin companies.

Figure 8: Topix constituents' average gross margin



Source: Bloomberg Finance L.P. As of February 8, 2024.

In summary

The long-awaited drive for corporate governance reform appears to be gaining traction in Japan. Corporates that are able to address investors' longstanding concerns have a significant opportunity to close profitability and valuation gaps, leading to potential medium-term outperformance. This makes it an opportune time for investors to reassess their exposure to Japanese equities. While managing country-specific allocations may be out of reach for some investors, an alternative simple implementation would be gaining exposure to the market via an EAFE equity strategy. The unique characteristics of the Japanese market present challenges, though. Many traditional factors like P/E, earnings revisions and ROE/ROIC do not work well in the Japanese context. Investment managers who have deep insights and experience in the Japanese market possess a competitive advantage in generating superior long-term returns. ■

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